

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 90-266-C - ORDER NO. 90-849 ✓
SEPTEMBER 5, 1990

IN RE: Generic Proceeding to Consider) ORDER APPROVING
 Intrastate Incentive Regulation) INCENTIVE REGULATION

This matter comes before the Public Service Commission of South Carolina (the Commission) by way of the Commission's decision to inquire into the prudence of modifying the traditional rate base regulation of the jurisdictional telephone utilities. By Order No. 90-370, issued in the instant docket on March 30, 1990, the Commission instituted a generic proceeding to receive evidence regarding intrastate incentive regulation. All telephone utilities, including local exchange companies and interexchange carriers, were made parties to the proceeding. A hearing was set for June 20, 1990, in the Commission's Hearing Room at 10:30 a.m. to receive evidence in this matter.

The hearing was duly convened before the Commission, the Honorable Marjorie Amos-Frazier, presiding. John M.S. Hoefer, Esquire, appeared on behalf of the South Carolina Cable Television Association (SCCTA) and SouthernNet of South Carolina, Inc. (SouthernNet); Elliott F. Elam, Esquire, appeared on behalf of the South Carolina Department of Consumer Affairs (the Consumer Advocate); D. Christian Goodall, Esquire, and Tiane L. Sommer,

Esquire, represented MCI Telecommunications Corporation (MCI); Francis P. Mood, Esquire, and Jay R. G. Ortiz, Esquire, represented AT&T Communications of the Southern States (AT&T); Frank R. Ellerbe, III, Esquire, appeared on behalf of Contel of South Carolina, Inc. (Contel); M. John Bowen, Jr., Esquire, represented GTE South and the South Carolina Telephone Coalition; Fred A. Walters, Esquire, represented Southern Bell Telephone & Telegraph Company (Southern Bell); William F. Austin, Esquire, represented Southern Bell and with James B. Wright, Esquire, also represented United Telephone Company of the Carolinas (United); and Marsha A. Ward, General Counsel, represented the Commission Staff.

The Commission considered the testimony of witnesses testifying on behalf of the Commission Staff, MCI, AT&T, Contel, SouthernNet, GTE South, South Carolina Telephone Coalition, Southern Bell, and United. The parties desiring to do so, duly filed briefs outlining their competing views relative to the design of and/or need for a modification to the traditional rate of return regulation of local exchange companies.

The Commission noted in Order No. 90-370, that as competitive forces have emerged in the telecommunications industry, both nationally and in the state arena during the post divestiture years, a trend across the country has developed to reassess the traditional rate of return regulation of telephone utilities. This reassessment has resulted in some jurisdictions adopting various alternatives to traditional rate of return regulation. The Commission established this docket to institute a generic

proceeding to address the issue of intrastate incentive regulation. In light of this reassessment, it is necessary for the Commission to answer the questions, "Is it necessary to revise the present rate of return regulatory approach, and if so, what type of changes should be adopted?"

NECESSITY OF REVISING TRADITIONAL REGULATORY METHODOLOGY

Competition in the Market Place

To answer the question of the necessity of revising the traditional rate of return regulation of local exchange companies, a look at the current operating environment must be had. Since the divestiture of AT&T, local exchange companies and especially the interexchange carriers have operated under a different set of regulatory guidelines both in the interstate and intrastate arena. Before 1982, there was relatively little competition as far as toll services were concerned, and that has changed decidedly in the post divestiture years. Such changes have caused 39 states to explore the need for regulatory reform, with over half of them already implementing revisions of their regulatory process. (TR. Vol. 2, p. 159). The Commission only needs to look at the number of interexchange carriers operating in South Carolina to determine that there is competition in the intrastate interLATA toll market. The Commission is aware of competition in the intraLATA market to the extent that SouthernNet is authorized to provide intraLATA service in competition with Southern Bell and the other local exchange companies. Additionally, several local exchange companies through separate subsidiaries have created their own long distance

companies which provide various MTS, WATS, private lines, and other types of long distance services to their customers. The Commission cites the examples of Community Long Distance and Low Country Carriers as just two examples of such. The Commission finds that there is competition in these markets and that such was testified to by Commission witness Walsh. (TR. Vol. 1, p. 34). Additionally, the Commission finds that there is competition in the provision of COCOT services (Id.) in billing and collection services, (TR. Vol. 1, p. 46), in the provision of ESSX and PBX services, (TR. Vol. 1, p. 47), as well as the advent of OPX lines, small aperture terminus, fiber ring carriers, carrier's carriers, SCANA fiber optic network, and shared tenant services in both the local service and long distance markets (TR. Vol. 1, p. 62). Additionally, there is competition in the provision of cellular service, yellow page directory advertising, and alternate operator services (TR. Vol. 2, p. 122). The Commission is of the opinion that these competitive services in a generic sense are pervasive throughout the intrastate market in South Carolina. Each local exchange company is either directly or indirectly affected by competition of services.

As was testified to by witness Spencer for Contel, Contel can be indirectly impacted by competition as it exists in other areas in the State. (TR. Vol. 1, p. 127). An example of the indirect effect of competition could be the intraLATA toll pool as testified to by witness Walsh. (TR. Vol. 1, p. 34). Witness Walsh eluded to the fact that if the revenues from the intraLATA toll pool are

reduced through competition, the local exchange companies participating in the pool will be impacted by the fact that they will receive less revenues from the pool than if there was no competition. The Commission is of the opinion that each local exchange company can be affected by the competitive nature of telecommunications services being provided in the State of South Carolina. Certainly, each local exchange carrier's services is subject to increasing competitive pressure. (See, e.g. TR. Vol. 1, pp. 12, 34-35, 46-47, 58-62; TR. Vol. 2, pp. 31-32, 43-46, 82-83, 90, 123-125).

Therefore, the Commission is of the opinion that the record in this instance establishes that in a generic sense there is competition to the services provided by the local exchange companies in South Carolina. For the purposes of this proceeding then, the Commission finds that there is sufficient competition to warrant consideration of a change in the traditional regulatory methodology.

Benefit to the Public

While the evidence has shown that competition is prevalent in the intrastate market place, the Commission must also answer in the affirmative that the public will benefit from the implementation of any changes before the Commission would approve such. The record contains evidence that the public interest includes both the ratepayer as well as the local exchange company. (TR. Vol. 1, pp. 87-88). The Commission finds that the public interest does include both the ratepayer and the local exchange

company. In that regard, the Commission must consider whether or not a change in the traditional regulatory methodology poses a risk to either or both the ratepayer or the local exchange company.

Among the benefits to be derived from a change in regulation would be the development by the LEC's of a modern telecommunications infrastructure so that economic development is enhanced for the betterment of all customers. Also, the move to an updated form of regulation would assure that large customers would not migrate off the network. (TR. Vol., p. 142). Consumers would receive stable, affordable rates, the prompt introduction of innovative services and a larger variety of products. (TR. Vol. 2, p. 143).

An incentive regulation plan differs from the traditional rate of return methodology in that incentive regulation would encourage LEC's to invest in new technology with a goal of providing improved services at lower costs. An incentive regulation plan would give LEC's a financial incentive to more rapidly market new products and services. The financial incentive of retaining some of the benefits from increased productivity would foster greatly improved productivity. This could lead to reduced costs of service in the long term. When combined with pricing flexibility, an incentive sharing plan would be much less complex and much less costly to administer as it is similar to traditional rate of return regulation in that regard.

AT&T witness Follensbee stated that "changes in the telecommunications industry, such as rapid advancement in

technology and the advent of competition in certain markets, warrant the consideration of an alternative to earnings regulation for the LECs. At its best, traditional earnings regulation fails to reward a company for improving its efficiency and productivity. In the worst instance, traditional earnings regulation can encourage inefficiencies and increase cost in the provision of the LEC's services." (TR. Vol. 1, p. 93). With the rate of return regulation, a LEC is incented up to the point of its authorized return, but there is no incentive beyond that point (TR. Vol. 2, p. 114).

Southern Bell's witness Walker enumerated a large number of benefits to ratepayers and to the LEC's if incentive regulation was adopted. Ratepayers would continue receiving affordable, quality basic local service provided by a financially strong competitive company with the public switched network remaining a viable and valuable source (TR. Vol. 2, p. 106). Communities would benefit from the favorable economic development that would result for the local exchange company investing in new technology and the LEC would benefit from the opportunity for financial stability and rewards (TR. Vol. 2, p. 107).

Based on the overwhelming testimony in the record before the Commission, the Commission finds that there is a public benefit to be derived from a modification of the traditional rate of return regulation. Such modification in the form of incentive regulation is evident from the testimony given by the witnesses in this proceeding. Additionally, any potential risks that may be

apparent, could be addressed on a case-by-case basis as each LEC, under the plan proposed by Commission Staff witness Walsh, would apply for approval of its particular incentive regulation plan.

In summary, the Commission finds that there is sufficient competition of a generic nature to warrant the implementation of a plan and that such a plan will inure to the public benefit, that of both the ratepayers and the local exchange companies.

TYPE OF PLAN TO BE IMPLEMENTED

After deciding the issue of whether a change in the traditional form of regulation should be made, and deciding that in the affirmative, the next logical step is what type of plan is best suited for the jurisdictional local exchange companies of South Carolina. The Commission is of the opinion that a plan that will permit and encourage the LEC's to become more technologically advanced, more innovative, more competitive and more capable of meeting future telecommunications needs of South Carolina is imperative. (TR. Vol. 2, p. 112). The Commission is satisfied with the status and achievements of its jurisdictional telephone utilities today, but the Commission recognizes that the industry is about to enter an era where the technology will move faster than imagined. This calls for a change in the traditional regulatory process.

The Commission Staff recommended an earnings sharing plan that would be optional to all LEC's and experimental lasting 3 to 5 years with a requirement for each LEC electing to participate in the plan to have a proceeding to establish a benchmark rate of

return (TR. Vol. 1, p. 13). Other features of the Staff's plan would provide that if the LEC earned 100 basis points above or below the benchmark return it would retain those earnings or losses. Earnings between 100 and 250 basis points above the benchmark would be split evenly between the LEC and the customer, and all earnings over 250 basis points above the benchmark would be returned to the customer. (TR. Vol. 1, p. 14). Mr. Walsh also proposed that the plan apply to all services (TR. Vol. 18); that LEC's under the incentive regulation plan file annual reports for monitoring purposes by the Commission Staff. Local exchange rates would remain subject to Commission approval requirements and thus no rate freeze or moratorium was needed (TR. Vol. 1, pp. 28, 49). For LEC's earning 100 basis points or more below the benchmark return, a traditional rate case filing would be allowed. (TR. Vol. 1, p. 25). The manner of refunds or sharing revenues would be separately handled for each LEC (TR. Vol. 1, p. 57) during the proceeding to establish a benchmark.

While other participants in the proceeding offered their plans, most witnesses supported the Staff's earnings sharing plan with some reservations. United supported Staff's proposed incentive plan (TR. Vol. 2, p. 145), as did AT&T (TR. Vol. 1, p. 93), Contel (TR. Vol. 1, p. 118), General (TR. Vol. 2, p. 53), and Southern Bell (TR. Vol. 2, p. 105). Mr. Whitehurst, witness for South Carolina Telephone Coalition, impliedly supported the plan in that the issues of optionality and rate of return were consistent with the Staff's plan. MCI was primarily concerned with including

safeguards in any plan, while SouthernNet witness Reynolds stated the Staff's plan did provide a reasonable framework within which his proposal could be implemented. (TR. Vol. 2, p. 13). However, Mr. Reynold's proposal was based in large part on the use of a fully distributed costing methodology applied to nine separate service categories. Not only did the SouthernNet proposal urge use of methodology recently rejected by this Commission (TR. Vol. 2, p. 28), but the witnesses also acknowledged that implementation of his proposal could well require a 100% increase in local exchange rates (TR. Vol. 2, p. 21), a result which the Commission believes would be contrary to the public interest concern to maintain universal service.

The main concern expressed by some LEC's is that Staff's proposal has a low range within which revenues would be shared. United proposed that the range for sharing above the threshold should be 250 basis points rather than 150 basis points (TR. Vol. 2, p. 146). As explained by witness Sokol, if the top of the range is set too low, the entire purpose of incentive regulation has been defeated because a company would have "incentive" to improve its operations only so far. "It [a sharing plan and its cap] has to reflect some real incentive for the Company in order to be effective." (TR. Vol. 2, p. 168). The Commission concurs. To limit the utility's ability to share in the benefits of its efforts destroys the entire concept of incentive regulation and, as such, that portion of Staff's proposal should be modified. Additionally, an earnings sharing plan fits into the current regulatory framework

better than alternative regulatory reforms such as price caps (TR. Vol. 1, p. 17), particularly in view of S.C. Code Ann. §58-9-330 (1976) which specifically allows the Commission to permit LEC's to share in profits derived from more efficient operations (TR. Vol. 2, p. 117).

Accordingly, the Commission will herein adopt an incentive regulation plan for South Carolina with the following provisions:

1. The incentive regulation plan will be an earnings sharing plan similar to that proposed by the Commission Staff with the modifications as noted herein.

2. The plan will last for a trial period of three years.

3. The plan will be optional to all LEC's in South Carolina.

4. The current quality of service standards will be maintained.

5. Each LEC opting for an earnings sharing plan will file its request with the Commission. The Commission will then establish a proceeding to address, inter alia, the establishment of a benchmark rate of return and the refunding method.

6. The benchmark return will be set on a return on equity basis or a return on rate base basis, as appropriate.

7. The floor will be 100 basis points below the benchmark. If earnings drop below the floor, an earnings sharing regulated LEC may then seek rate relief from the Commission. No rates are frozen under this plan.

8. The threshold will be 100 basis points above the benchmark. Any earnings or losses between the floor and the threshold will be retained by the LEC.

9. The ceiling will be 250 basis points above the threshold. Any earnings experienced by the LEC between the threshold and the ceiling will be shared on a 50/50 basis with the company's ratepayers.

10. Any earnings above the ceiling will be refunded or credited to the ratepayers.


11. Any LEC opting to participate under the earnings sharing plan shall continue to file an annual report for monitoring purposes with the Commission. Additionally, any participating LEC will not be relieved from any other filing requirements with the Commission.

12. The Commission will audit the earnings of any LEC opting under the earnings sharing plan at the end of twelve months to determine the impact of incentive regulation on that LEC.

13. The goal of affordable, universal service will be maintained and the Commission will continue its regulatory oversight and responsibility.

IT IS SO ORDERED:

BY ORDER OF THE COMMISSION:


Chairman

ATTEST:


Executive Director

(SEAL)